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FINANCE / UNITED STATES

3i Chief Warns of Secondary Buyout Bubble

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Chief executive of the ***3i*** private equity group, ***Michael Queen*** has warned that a bubble is developing in the market for secondary buyouts (SBOs). These "pass the parcel" transactions occur when one private equity (PE) group sells a company in its portfolio to another. ***CFW*** believes that although private equity is making a healthy recovery this year, investors should be alert to the more opportunistic aspects of the SBO flurry.

US and Europe Top For SBOs
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Research by *Ernst and Young* covering the first nine months of the year does indeed show a rise in deal values occurring alongside a marked uptick in secondary buyout activity. During the study period, average price to earnings multiples of buyouts climbed to 17.2x from 10.5x the year before, while the contribution of secondary buy-outs to overall buyout volume rose to 23% compared to 11% for the whole of last year. By value, secondary buyouts accounted for a fifth of the total market for the whole of last year and a record 49% for the first nine months of 2010. Researchers at *Preqin* found that during this period, there were 68 secondary buyouts in Europe, a record high of 46% of total leveraged buyout activity. In North America, the number of deals had more than doubled in the past three years to 56.

Mr Queen is concerned that the trend is being primarily driven by "overhang" - that is to say the difference between funds raised and equity invested. During the financial crisis, PE companies were unable to spend the US$470bn they had amassed in their fund-raising pools because the debt markets they rely on to fund their acquisitions froze over. Now that credit conditions have thawed, they are in a rush to disburse this money before the pools expire and the money has to be returned to investors. This leads to intense competition over acquisition targets, which in turn drives up prices. According to a thesis put forward by ***Stefano Bonini*** of ***New York University's Stern Business School*** SBOs are more appealing than initial buyouts for PE groups looking for a quick return, because the first buyer has already done the hard, transformational work. Once the second buyer has bought the company, all they need to do is sit there and count on abnormally cheap high-yield financing conditions and the sharp, post-crash ascent of transaction multiples combining to maximise eventual returns. In this sense, Bonini argues in a recent paper, SBOs are essentially a form of arbitrage that exploit mispricing in the debt and equity markets.

For the seller, the preference for secondaries in the European market can to some extent be explained by the mixed receptions that have attended several high-profile PE-backed IPOs this year. In the US, where many PE companies are based, the prospect of tax hikes on asset sales may also be prompting many to sell now rather than later. When PE companies sell on assets they can expect to book a fee from the sale plus a percentage of any increase in value (the "carry interest"). Although it is uncertain whether it will succeed, the administration in Washington would like to raise capital gains tax on these profits from 2011 onwards to bring it in line with income tax.

While secondary buyouts are mutually convenient for the PE groups concerned, their investors may have cause to be wary. Ultimately, it will impact on returns if a company is sold at a time largely determined by the PE partners' personal tax needs. For the unfortunate investor with exposure to both the buyer and seller funds, secondary buyouts are especially frustrating. They will still own that asset, just as they did before, with the main difference being that some of their potential return on it will have been diverted into the fees and carried interest of the seller. But the real losers could turn out to be the debt providers for the buyers, because, as Bonini argues, mispriced debt and equity essentially means mispriced risk.